SECURITIES LITIGATION

Applying *Morrison* to American Depositary Receipts

In the wake of the Supreme Court's Morrison *decision concerning the applicability of Section 10(b) of the Exchange Act to offshore transactions, there is uncertainty as to the status of transactions in American depository receipts. As a result, foreign issuers may be hesitant to create ADR programs or terminate existing programs, but this should not necessarily be the case.*

By Paul Dudek

In *Morrison v. National Australia Bank*,[1] the US Supreme Court swept away nearly 40 years of Circuit Court jurisprudence relating to whether offshore securities transactions are subject to anti-fraud claims under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act). In the wake of that decision, there have been numerous lower court opinions applying the holding of *Morrison* to a wide range of instruments, transactions and securities, including American depositary receipts (ADRs).

For the many hundreds of foreign companies that have established sponsored Level I ADR programs, a critical question is whether the existence of such an ADR program makes them more susceptible to Section 10(b) claims in light of *Morrison's* holding. Developing a well-reasoned answer to that question is made more complicated because many judicial opinions relating to ADRs seem to reflect some level of misunderstanding of how ADRs work.

In the wake of this uncertainty, foreign issuers may be hesitant to create Level I ADRs, and other foreign issuers may terminate their existing Level I ADR programs, both to the detriment of US investors and the US market as a whole. This article examines recent court decisions and regulatory pronouncements relating to ADRs and concludes that *Morrison*, when properly applied to Level I ADRs, should preclude a Section 10(b) claim against the foreign issuer whose securities underlie the ADRs.

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The *Morrison* Decision

Morrison involved anti-fraud claims under Section 10(b) by purchasers who had bought shares of a foreign corporation, National Australia Bank (NAB), on a foreign stock exchange. NAB had registered its securities under the Exchange Act, and its filings with the US Securities and Exchange Commission (SEC) contained the alleged misleading disclosures. NAB's ADRs were listed on the New York Stock Exchange, although, in an ironic twist for securities lawyers, Robert Morrison, the named plaintiff who had purchased the listed ADRs, was dismissed from the proceedings in a lower court decision for failure to allege damages.

The facts before the Supreme Court involved a classic F-cubed scenario: *foreign* plaintiffs had purchased securities of a *foreign* company on a *foreign* stock exchange and were trying to bring a case in US courts based on the anti-fraud provisions of the US federal securities laws. The Supreme Court reviewed decades worth of Circuit Court decisions which had developed the conduct and effects tests for weighing whether the federal securities laws should apply to securities transactions outside the United States.

In unequivocal language, the Supreme Court held that the Circuit Courts' decisions, and the conduct and effects tests created by those decisions, were wrongly reasoned because, simply stated, Section 10(b) of the Exchange Act does not have an extraterritorial reach. Instead, the Court stated: "it is in our view only transactions in securities listed on domestic exchanges, and domestic transactions in other

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securities, to which Section 10(b) applies."[2] It is this two-part test that must be applied when determining the reach of the federal securities laws to transactions involving foreign securities and foreign issuers.

American Depositary Receipts

ADRs are separate securities that represent the ordinary equity securities of a foreign issuer.[3] In a typical scenario, those ordinary securities are listed and traded on a non-US stock exchange, with clearance and settlement in those securities taking place through a non-US clearing house. US investors often have difficulty obtaining direct access to foreign stock exchanges and clearing facilities in order to buy and sell foreign securities. ADRs were developed to facilitate US trading in foreign securities by creating a US-tradeable instrument that merely represents foreign securities.

ADRs were developed to facilitate US trading in foreign securities by creating a US-tradeable instrument.

From an operational point of view, ADRs are issued by a US bank against the delivery to the bank (or more likely its custodian in a foreign country) of the shares of a foreign issuer. The bank holds the shares on deposit and issues ADRs in the United States to the investor who delivered the shares. Because ADRs are issued by a US-based financial institution, they are able to be cleared and settled in accordance with standard practices in the United States. In reverse, the bank will deliver out the deposited securities on the request of a holder upon cancellation of the ADRs.

In a very rudimentary sense, ADRs bear a faint resemblance to a laundry ticket: a laundry ticket represents shirts that have been delivered to a dry cleaner, just as an ADR represents shares that have been delivered to the depositary bank. One can transfer ownership of the shirts by buying and selling the laundry ticket, just as one can transfer ownership of foreign securities by buying and selling ADRs. Of course, ADRs have much more substance to them than laundry tickets; depositary banks can provide a number of high value-added services to holders of ADRs that dry cleaners do not, such as converting foreign currency dividends into US dollars and forwarding the proceeds to holders, and facilitating tax refund requests and voting of shares. But the analogy to the dry cleaners should be kept in mind when considering who benefits most from having a tradeable receipt.

The issuance of ADRs against the delivery of ordinary shares is viewed as being a transaction that is subject to registration under the Securities Act of 1933 (Securities Act). The SEC has adopted an easy registration form for this simple transaction: Form F-6. Under this form, for purposes of the Securities Act, the "issuer" of the ADR is not the US bank but is the "legal entity created by the depositary contract" that governs the contractual terms of deposit relating to the ADR. Form F-6 provides disclosure about the terms of deposit governing the ADRs but no information about the foreign issuer (other than its name).

Much of the confusion around ADRs stems from the arcane nomenclature used by ADR insiders: ADRs can be sponsored or unsponsored, and sponsored ADRs can be further categorized into Levels I, II or III. These unique terms of art, which are well-understood and loved by ADR aficionados, mainly denote the extent to which the foreign issuer has registered securities with the SEC.

Unsponsored ADRs are issued by a depositary bank without any involvement of the foreign issuer. These ADRs are, in effect, two-party contracts between the depositary bank and a holder of ADRs, under which the bank agrees to handle the deposited securities in accordance with the terms of deposit. These terms of deposit – i.e., the two-party contract – are set out in the ADR certificate itself. By holding an ADR, an investor is deemed to agree to those terms. Unsponsored ADRs are traded only in the US

over-the-counter (OTC) market and are not listed on any US stock exchange.

In the same manner, *sponsored ADRs* are, in effect, three-party contracts in which the foreign issuer joins in agreeing to the terms of deposit. Notwithstanding the three-party nature of a sponsored ADR, the foreign issuer and the depositary bank play essentially reactive roles, although the depositary bank is the participant in charge of the day-to-day operation of the ADR program. It is investors who actively deposit and withdraw foreign shares, and it is the depositary bank that reactively issues and cancels ADRs, and accepts and delivers out underlying shares, as and when requested by investors. From the point of view of the foreign issuer, the depositary bank is merely another holder of record of its shares, serving as an intermediary which holds securities on behalf of others.

Level I ADRs are sponsored ADRs that represent securities of a foreign issuer that is not registered with or reporting to the SEC under Section 12 or 15(d) of the Exchange Act but rather maintains the exemption from registration under Exchange Act Rule 12g3-2(b); like unsponsored ADRs, Level I ADRs trade solely in the US OTC market. *Level II ADRs* are sponsored ADRs that are listed on a US stock exchange (and therefore the issuer will be registered under Section 12(b) of the Exchange Act) but the foreign issuer has not sold ADRs in the United States to raise capital in an SEC-registered offering. *Level III ADRs* are sponsored ADRs that are listed on a US stock exchange and the foreign issuer has raised capital in the United States through an SEC-registered offering.

From a regulatory point of view, there is a large difference between Level I ADRs on the one hand, and Level II and III ADRs on the other: the latter two are subject to all of the SEC's disclosure and other requirements applicable to foreign registrants, including the disclosures and certifications required by the Sarbanes-Oxley Act of 2002. Issuers with Level I ADRs, however, are not subject to any of those requirements and make no filings with the SEC, other than co-signing the Form F-6 registration statement which is filed by the depositary bank to register the ADRs under the Securities Act.

Court Decisions Relating to ADRs

Pinker v. Roche[4] was a pre-*Morrison* case in which the plaintiff alleged that a foreign issuer with a Level I ADR program had violated Section 10(b) by the issuer's alleged inadequate disclosure relating to a price-fixing conspiracy involving the company. The court found that it could exercise personal jurisdiction over the foreign company. Although this decision contains a largely accurate discussion of how ADRs work, it is not without its flaws.

The court stated its belief that US investors should feel "more secure" in holding ADRs because "they are subject to reporting and regulatory requirements under the Securities Act and the Exchange Act."[5] However, while it was true that the foreign company had co-signed a Form F-6 registration statement that was filed by the depositary bank under the Securities Act, the SEC has noted that Form F-6

> need disclose only information regarding the depositary arrangement. No information about the issuer of the deposited securities (other than its identity) need be included.[6]

With respect to Exchange Act requirements, at the time of the *Pinker* decision, and as the court noted, foreign issuers with a Level I ADR program were required to submit home country disclosure documents to the SEC in order to maintain the exemption from Exchange Act registration provided under Rule 12g3-2(b). In 2008, the SEC completely revised Rule 12g3-2(b) so that the exemption now relies of the Internet posting of home country disclosure materials and foreign companies have been expressly instructed not to send these materials to the SEC. Unlike the dicta in the *Pinker* decision, it is far more accurate to say that the regulatory protections afforded to investors under the Securities Act and the Exchange Act for Level I ADRs, and thus investors' expectations of those protections, are much

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more limited, especially when compared with companies that are subject to far more comprehensive regulatory obligations because they are listed on a US stock exchange.

Also, the *Pinker* court demonstrated some degree of misunderstanding about the ADR market when it stated that without the regulatory protections (which actually are not extensive as noted above), foreign companies like the defendant might have a more difficult time obtaining American capital through ADR facilities. While that might be true for Level III ADR programs, Level I ADR programs do not involve capital raising. As discussed later, Level I ADRs are designed primarily for the benefit of US investors who seek to purchase, hold and sell securities of foreign companies.

As noted, *Pinker* involved questions of personal jurisdiction, implicating the *International Shoe* analysis of whether "traditional notions of fair play and justice" justified haling a foreign corporation into a US court.[7] The *Morrison* tests relating to the extraterritorial reach of the US federal securities laws requires a different approach and analysis.

Level I ADR programs do not involve capital raising.

In the recent case of *Stoyas v. Toshiba*,[8] holders of unsponsored ADRs that had been purchased in the US OTC market brought an anti-fraud class action claim under Section 10(b) against Toshiba, a Japanese issuer whose securities fell sharply in price after allegations of improper accounting practices became public in April 2015. Plaintiffs argued that their claims were valid under both prongs of the *Morrison* test. The court found ample precedent in holding that transactions effected in the US OTC market are not transactions in securities listed on a national securities exchange. With respect to the second prong under *Morrison,* the court held that transactions in the US OTC market, effected through US broker-dealers and US clearance and settlement systems, were domestic transactions even though some of the purchases in those transactions were effected from outside the United States.

It might appear at first glance that the second prong of *Morrison*, the domestic transaction test, is readily met in cases involving US OTC transactions. But the court in *Toshiba* made a more careful and discerning analysis that turned on the nature of the securities in question: unsponsored ADRs. The court favorably mentioned Toshiba's arguments that the subject securities transactions did not involve the company's active participation in any way, noting the unique characteristics of unsponsored ADRs.

Transactions effected in the US OTC market are not transactions in securities listed on a national securities exchange.

The court came to the correct conclusion that US OTC trading in unsponsored ADRs was not sufficient to meet *Morrison's* domestic transaction test. Like other courts, though, the court in *Toshiba* demonstrated some lack of familiarity with ADRs. The court noted its belief that foreign issuer "stocks are purchased by an American depositary bank on a foreign exchange and then resold as a different kind of security (an ADR) in the United States."[9] As described above, after setting up an ADR facility, the US depositary bank becomes a largely passive participant, issuing ADRs upon the deposit of foreign shares, and cancelling ADRs and delivering out foreign shares, only as and when requested by investors. It is these third party investors, far removed and independent actors from both the issuer and the depositary bank, who are the active catalysts behind the ADR market.

Applying *Morrison* to Level I ADRs

In *Toshiba*, the court placed a heavy emphasis on the fact that the ADRs were unsponsored and that

the foreign issuer had not undertaken any affirmative act relating to the ADRs. But it is not a foregone conclusion that just because ADRs are "sponsored" by a foreign issuer that it has a degree of activity relating to the ADRs sufficient to justify subjecting it to claims under Section 10(b). In fact, the opposite is true.

In applying *Morrison*, little significance should be placed on the geeky nomenclature used with respect to "sponsored" ADRs. Indeed, the word "sponsored" erroneously connotes a level of active engagement that largely is not found in most Level I programs. Significantly, a Level I ADR does not involve capital raising by the foreign issuer or a listing on a US stock exchange. If a foreign company sought to publicly raise funds from US investors, it would have to register the offering with the SEC and most likely list its securities on a US stock exchange. Instead, with a Level I ADR program, shares that are trading on a foreign stock exchange are purchased by independent third-party market participants, such as US brokers, US institutions and other market participants, who deliver them to the depositary bank in exchange for ADRs that may then be freely re-sold in the US OTC market.

On a day-to-day basis, the foreign issuer has little involvement with the administration of a Level I ADR program. ADRs are issued and cancelled at the request of investors, not the issuer. The size of the ADR program, and the level of trading, is determined solely by the extent of US investor interest in the foreign issuer. Sponsorship, or lack thereof, of ADRs has little impact on these important measures of active engagement.

The primary beneficiaries of sponsored ADRs are US investors, not the foreign issuers whose securities underlie those ADRs. Unsponsored ADRs can be created for virtually any foreign issuer whose securities are listed on a foreign stock exchange and multiple depositary banks can issue fungible unsponsored ADRs for the same issuer. In this situation, a holder of an unsponsored ADR may have no control, or even knowledge of, which depositary bank to deal with if there is a problem with an unsponsored ADR. With a sponsored ADR, a holder benefits from having a contractual relationship with a single depositary bank.

In addition, to bring the point further home, the SEC itself has long recognized that the establishment of a Level I ADR program should not be treated as accessing the US capital markets in an active manner. This bedrock regulatory principle dates back almost 40 years and recently has been reaffirmed: that issuers with Level I ADRs are not sufficiently active in the US capital markets to justify requiring them to register under Section 12(g) of the Exchange Act.

When Congress enacted the Securities Act Amendments of 1964, every issuer whose securities were traded in interstate commerce, that had more than $1 million in assets and that had 500 or more shareholders of record became subject to the registration requirements of new Exchange Act Section 12(g). At the time, there was a pressing question as to how Section 12(g) would apply to foreign companies, many of which would appear to easily come within the registration thresholds.

In crafting an exemption for foreign companies, the SEC articulated a standard which made a distinction between those foreign issuers "which have not actively sought a public market for their securities in the United States" and those that have.[10] The former would be entitled to the exemption from registration afforded by Rule 12g3-2(b) and the latter would be subject to Section 12(g)'s registration requirements.

In 2008, the SEC thoroughly revised the mechanics underlying how foreign issuers establish and maintain the exemption provided by Rule 12g3-2(b).[11] At the time, the SEC had the opportunity to revisit the essential tenets underlying the exemption in light of the kinds of US market activities that foreign issuers frequently undertake today, such as Rule 144A offerings, trading on markets such as OTCQX, contacts with US press and analysts, and sponsored Level I ADRs.

In its proposal to revise Rule 12g3-2(b), the SEC noted that it was well aware of

> the globalization of securities market, advances in information technology, the

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> increased use of ADR facilities by foreign companies to trade their securities in the United States, and other factors ... as well as the increased amount of US investor interest in the securities of foreign companies.[12]

When adopting the revised exemption, the SEC cited back to its initial articulation that the exemption was available to foreign companies that "have not obtained a listing on a national securities exchange or otherwise sought a public market for their equity securities in the United States."[13] Furthermore, the SEC also noted that with the exemption, foreign issuers could have their equity securities "traded on a limited basis in the over-the-counter market in the United States while avoiding registration under Exchange Act Section 12(g)."[14]

Conclusion

ADRs have been around since the 1920s, serving the needs of US investors as they seek to diversify their stock portfolios to avoid having their holdings solely comprised of US companies and to take advantage of investment opportunities afforded outside the United States. Level I ADRs have provided an effective platform for US investors to buy and sell foreign securities in the United States, thereby reducing the costs and risks that would be associated with buying, holding and selling securities directly on a foreign stock exchange or other non-US trading market. With a proper reading of *Morrison*, there are strong arguments that sponsored Level I ADRs should not by themselves provide a basis for a Section 10(b) claim against a foreign issuer whose securities underlie the ADRs. As a result, issuers should be more at ease in maintaining a sponsored Level I ADR program in order to assist US investors in holding its securities.

Notes

1. 561 U.S. 247 (2010).
2. *Id.* at 268.
3. Although it is dated, the SEC published a good overview of how ADRs are regulated under the federal securities laws in a request for comment relating to ADRs. *See* American Depositary Receipts, SEC Release No. 33-6894 (May 23, 1991) (1991 SEC Release). A briefer SEC description relating to ADRs can be found in Appendix A to "Study on the Cross-Border Scope of the Private Right of Action under Section 10(b) of the Securities Exchange Act of 1934", SEC Staff Study, April 2012, available at *https://www.sec.gov/news/studies/2012/929y-study-cross-border-private-rights.pdf*.
4. 292 F.3d 361 (3d Cir. 2002) (*Pinker*).
5. *Id.*, at 372.
6. *See* 1991 SEC Release, at Section III.A.1.a.
7. *See* Pinker, at 372.
8. 2016 WL 3563084 (C.D. Cal 2016) (*Toshiba*).
9. *Id.*, at 10.
10. *See* Adoption of Rules Relating to Foreign Securities, SEC Release No. 34-8066 (April 28, 1967).
11. *See* Exemption from Registration under Section 12(g) of the Securities Exchange Act of 1934 for Foreign Private Issuers (adopting release), SEC Release No. 34-58465 (September 5, 2008).
12. *See* Exemption from Registration under Section 12(g) of the Securities Exchange Act of 1934 for Foreign Private Issuers (proposing release), SEC Release No. 34-57350 (February 19, 2008).
13. *See* note 11, above.
14. *Id.*